

Project Notes

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Lessons Learned from the Ahmedabad Municipal Bond

Municipal bonds are now accepted as a viable option for financing urban infrastructure in India. Recent Government of India issuance of guidelines for tax-exempt bonds will only expand capital market interest in the municipal debt market. Last year, the FIRE project evaluated the bond issued in 1998 by the Ahmedabad Municipal Corporation, India's first municipal bond not backed by a state guarantee, and identified key lessons for other municipalities that are considering this means of mobilizing resources. This Project Note summarizes the evaluation's findings about obtaining a credit rating, structuring the bond and transaction documents, and using the bond proceeds.

In January 1998, the Ahmedabad Municipal Corporation (AMC) issued Rs.1,000 million (US\$25 million) in bonds to partially finance a Rs. 4,393 million (US\$110 million) water supply and sewerage project. This was a remarkable achievement since it was the first municipal bond issued in India without a state guarantee and represented the first step toward a fully market-based system of local government finance. The AMC had previously instituted significant fiscal and management reforms, with technical assistance from USAID's FIRE project, including improved tax collection, computerizing the accounting system, strengthening AMC's work force and financial management, and developing a comprehensive capital improvement program. These reforms laid the necessary groundwork for AMC's bond issue and successful implementation of the infrastructure project.

Laying the Groundwork

Local Reforms

Public sector reform and resource base expansion are often necessary precursors of a bond issue. During

Role of USAID's FIRE Project

The FIRE project's partnership with the AMC began in 1994 with the preparation of an urban environmental workbook and an environmental risk assessment. In this exercise, the FIRE staff helped AMC carry out financial analyses and prepare a corporate investment plan. The investment plan, prepared in conjunction with the Infrastructure Leasing and Technical Services Ltd. (IL&FS), helped AMC to design a water supply and sewerage project. The FIRE project also assisted CRISIL to develop a methodology for carrying out credit ratings of urban local bodies (ULBs) in India. Ahmedabad was the first city where this methodology was applied. In addition, the FIRE project helped create the City Managers Association of Gujarat in 1998 and sponsored participation of AMC staff and elected leaders in training programs and study tours to build their capacity to undertake and sustain reforms. The FIRE project's multifaceted assistance to the city of Ahmedabad played a vital role in developing the bond issue.

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a deteriorating financial situation in 1994, AMC launched a major effort to improve revenue collection with a focus on octroi¹ and property taxes. Due to these measures, AMC was able to turn around its financial position and achieve a closing cash surplus of Rs. 2,142 million (US\$54 million) in March 1999. In addition, management innovations introduced by the municipal commissioner and supported by staff and elected officials helped AMC to change its image among the local citizenry.

Project Development

AMC prepared a capital investment plan of Rs. 5,973 million (US\$150 million) for 1996/97 to 2001/02, which included a water supply and sewerage component for Rs. 4,393 million (US\$110 million). AMC proposed to meet 30 percent of the total investment from internal accruals, while mobilizing the remaining amount through a municipal bond and loans from financial institutions. The financial viability of these investments was determined on the basis of the Corporation's overall financial position, rather than on the viability of the water and sewerage sector alone. Thus, the project was structured within an urban financial framework that was predicated on receipt of significant transfers from general corporation revenues such as octroi and property taxes.

Credit Rating

In 1996, Ahmedabad became the first city in India to request and receive a credit rating for a municipal bond issue. CRISIL, an independent rating agency, first assigned a credit rating of "A+" to Ahmedabad's municipal bond. Following this initial rating, AMC revised the financial structure of the bond offering and added several credit enhancement features, including a "no lien" escrow account of octroi taxes collected at ten collection centers. This financial mechanism is referred to in India as a structured debt obligation. However, because the city pledged all octroi taxes and other income to bondholders in the event that revenues from the ten collection centers were insufficient to make debt service payments, the Ahmedabad issue was in reality a general obligation bond. With these modifications to the bond financing structure, AMC received an improved rating of "AA."²

Structuring the Bond

Bond Structure

AMC's general obligation bond contained several credit enhancement measures (more commonly found in

¹ Octroi refers to a levy on goods brought into the limits of a city for consumption, use, or sale in the city.

² The bond's credit rating was put on watch in August 1999 when the State of Gujarat announced its intention to abolish octroi. State and AMC officials are committed to meeting their obligation to repay investors on schedule.

revenue bond offerings) designed to address political and repayment risks. These measures, in addition to the "no lien" escrow account for collection of octroi revenues, included innovative credit enhancement concepts such as a sinking fund for principal repayment, an annual debt service coverage ratio of 1.5, and property pledges with a 1.25 asset coverage ratio. However, in future bond offerings, greater planning and attention to details will be required to ensure the enforceability of these special covenants.

Improving Transaction Documents

The key financial documents in a municipal bond transaction are the disclosure (prospectus) document and trust indenture.

PROSPECTUS

While the prospectus for the AMC bonds provided a general overview of the economic, environmental, and fiscal condition of the AMC, and identified internal and external risks to investors, the degree of detail and specificity fell below international norms. In addition, it appeared at times that the prospectus attempted to explain away risks rather than provide the investor with all the necessary information to reach an independent evaluation of those risks. The prospectus was written to comply with disclosure guidelines of the Securities and Exchange Board of India (SEBI), which were designed for corporate offerings. This occurs in many countries and can be addressed by developing separate SEBI guidelines for municipal bonds. SEBI launched such an initiative as part of the Malegam Committee review of existing disclosure guidelines. These guidelines for municipal bonds should:

- provide the investor with sufficient detail, specificity, and information to reach an independent evaluation of risk; and
- clearly define all covenants, especially debt service covenants.

TRUST INDENTURE

A trust indenture is a binding legal agreement between an issuer and a trustee acting on behalf of the bondholders. AMC's trust indenture lacked sufficient specificity in many critical areas. As the market matures, investors will demand greater specificity in provisions relating to security pledges and perfection of all security interest at bond closing. The Ahmedabad bond prospectus and trust indenture are in need of substantial modification to fully inform investors of the risks and circumstances of the bond offering and to properly secure the financial interest of the bondholders. Development of a model trust indenture would help avoid future shortcomings in the structure and security of bond transactions and enhance investors' comfort in these financial undertakings.

A model trust indenture should insure that:

- all security interest is in place at the time bonds are issued or shortly thereafter;
- all credit enhancements discussed in the prospectus are included in the trust indenture;
- to manage interest rate risk, call provisions or redemption clauses are included (they allow an issuer to call bonds early and take advantage of market conditions to refinance at lower rates); and
- the trustee's duties are precisely defined and automatically triggered by specific actions.

In a bond financing, the trustee is the custodian of funds and official representative of bondholders. As such, a trustee insures compliance with the terms of the bond trust indenture and represents bondholders to enforce the contractual obligation of the issuer. It is in the best interest of the issuer, trustee, and bondholders if the trustee's responsibilities are established in the trust indenture without discretion and the trustee actively pursues those responsibilities on the bondholders' behalf. AMC's bond indenture provides an extraordinary level of discretion to the trustee, which should be avoided in future bond offerings. As India's bond market matures, greater specificity of the trustee's responsibilities and greater attention to bondholders' interest will be required.

Transaction Costs

The transaction costs for the AMC bonds, including underwriters, brokers, and legal fees, as well as advertising and printing expenses, equaled 2.89 percent of the bond offerings or Rs. 28.9 million (US\$722,500). This excludes stamp duty cost. A state government guarantee of AMC bonds would have resulted in considerable savings in transaction costs. However, a state government guarantee fee, annually assessed at one percent of outstanding principal balance, would have cost AMC Rs. 49.9 million (US\$1.25 million). for this particular financing. This savings more than offsets the higher transaction costs.

Using Bond Proceeds

Project Implementation

In the bond prospectus AMC pledged to establish special project sanctioning procedures to reduce project delays and to appoint private project management consultants to facilitate the process of project design, approval, tendering, construction supervision, quality control, and payments. AMC did not, however, follow through on these pledges. The lack of specialized project management support and AMC's normal approval process were partly responsible for delays in project implementation. Under pressure of an impending water

The Raska Water Project

Facing a very severe drought situation in August 1999, city officials decided to use the bond proceeds together with a Housing and Urban Development Corporation (HUDCO) loan, backed by USAID's Housing Guaranty program, to build the Raska water project. Designed to supply 6.5 crore (65 million) gallons of water a day to the city, the project consisted of constructing a pump house and laying 42 km of pipeline — most more than two meters in diameter — to bring water to the city. To ensure that the project would be completed by the end of March 2000, the municipal commissioner personally took charge of project implementation and obtaining necessary construction approvals from state and central government bodies.

The entire project was completed in 130 days, a record for engineering projects in India. The municipal corporation worked in partnership with two private contractors to coordinate 32 sub-contractors from all parts of India, whose 4,000 workers labored around the clock. Today, the Raska project supplies water to 60 percent of the city's population. The AMC can provide treated water to all residents for two hours in the morning and half an hour in the evening. Timely completion of the project not only saved Ahmedabad from severe water shortages during the summer of 2000, but also it provided a permanent and reliable source of surface water for years to come.

Source: Ahmedabad Municipal Corporation

crisis, the AMC rapidly expended bond proceeds to successfully implement an emergency bulk water supply scheme, the Raska Water Project, in a record five months.

Spending Bond Proceeds

Although criticized in certain circles in India and abroad, the two years that AMC took to use most of the bond proceeds is within U.S. norms for similar projects. Because interest rates dropped after AMC bonds were issued, the income AMC received on invested bond proceeds fell below the level of interest payments on the outstanding bonds, creating what is known as "negative arbitrage." AMC claims, however, that this availability of cash permitted it to obtain highly competitive tenders from the private contractors, which came in at 10 to 15 percent below the estimated cost. AMC estimates that this more than offset the loss of interest on the debt.

Utilization of bond proceeds should be accelerated to the extent possible. Before actual issuance of bonds, municipal corporations should have in place the following arrangements: a phased capital investment and financing plan for project implementation; identification of benchmarks for project commencement and completion; final tender documents for the proposed projects(s); and a separate project implementation group and project officer who will monitor the progress of works.

Summary of Conclusions

Great strides have been made in India in evolving the policy and legal framework for local government access to capital markets. Municipal bonds are now available as an option for financing urban infrastructure. Public financing concepts are well understood by the financial community and are becoming familiar to the local government sector. However, to routinely access capital markets for municipal bonds, ULBs will have to strengthen their capacity to develop commercially viable projects. This will require appropriate pricing of services, improved cost recovery mechanisms, improved accounting and financial management systems, enhanced professionalism of the work force, improved service delivery systems, and development of capital investment plans. To complement project development, ULBs will have to institute efficient project management systems and procedures to reduce time delays and cost overruns. The most critical factor for obtaining market finance will be a healthy municipal revenue base.

Furthermore, implementation of public finance concepts in the form of disclosure and transaction documents for municipal bonds needs to be improved to avoid financial difficulties and negative market consequences in the future. Adoption of a model prospectus and trust indenture would help address those shortcomings, as would the adoption of special disclosure guidelines by SEBI for local government bond offerings. Advanced public finance mechanisms, including revenue bonds, concession contracting and special purpose vehicles financing, will also require greater attention to legal documentation to be fully successful in India.

Chetan Vaidya, FIRE Principal Urban Management Advisor, and Brad Johnson, FIRE project consultant, wrote this *Project Note*. It is taken from their report, *Lessons Learned: Ahmedabad Municipal Bond and Water Supply and Sewerage Project*, August 2000. The report is available from the FIRE office in New Delhi and TCGI in Washington, DC. All *Project Notes* are available online at www.dec.org.

The mission of the Indo-US FIRE(D) Project is to institutionalize the delivery of commercially viable urban environmental infrastructure and services at the local, state and national levels. Since 1994, the Project has been working to support the development of demonstration projects and of a sustainable urban infrastructure finance system. Now, the Project is also pursuing this mission through:

- Expansion of the roles of the private sector, NGOs and CBOs in the development, delivery, operation and maintenance of urban environmental infrastructure;
- Increased efficiency in the operation and maintenance of existing water supply and sewerage systems;
- Strengthened financial management systems at the local level;
- Development of legal and regulatory frameworks at the state level;
- Continued implementation of the 74th Constitutional Amendment; and
- Capacity-building through the development of an Urban Management Training Network.

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